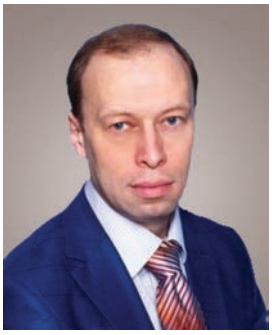
ANCILLARY LEGAL RISKS IN OIL SERVICES CONTRACTS (FROM PERSPECTIVE OF RUSSIA AND CENTRAL ASIA)



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Abstract

Risk assessment plays a significant role in negotiation and drafting of oil services contracts. There are diverse types of such risks which may occur during production process or compliance with legal regulation adopted in the states where the Contractor has its residence and where it delivers goods or provides services. The Contractor should be aware of sanctions, anticorruption policy and mandatory rules of public law governing taxation, currency control and administrative offences. Although these issues have ancillary character in terms of provision of oil services they should be considered by the parties during negotiations as there are several tactics to address them in contracts. This article will demonstrate how it is important to choose the correct wording in drafting relevant clauses if the Contractor is going to deliver goods and/or provide services in Russia or Central Asia.

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I. INTRODUCTION

Although the subject of this research is devoted to ancillary legal risks arising from the performance of oil services contracts their significance is high. As the Contractor bears the burden of characteristic performance it should consider all impediments which may occur in any time regardless of due and fair behaviour of the parties. Usually these impediments may be hardly predicted as they are beyond the parties' control and reflect permanently changeable policy in one state and the entire world.

The Contractor may face unfriendly measures imposed by the state of its residence against the local state where it is going to deliver goods or provide services. For example, sanctions in the Oil Industry, or vice versa, imposed by the local state to obtain excessively detailed disclosure of corporate structure of the Contractor as a result of implementation of Anti-Corruption Policy and Ownership Disclosures adopted by the Client. In addition, there are also numerous tax, currency and other administrative requirements present in the national laws which the Contractor must comply with in its daily business activity.

During negotiations, the Client tries to secure itself from any negative consequences which may occur due to violation of the such requirements and attempts to shift the burden of liability to the Contractor which may be exposed not only on loss of revenue (in the

event of early termination of the contract) but also payment of penalties and damages. To avoid such consequences, it needs to understand the legal nature of measures, make correct risk assessment, propose reasonable distribution of risks between the parties and use legal instruments enshrined in the applicable law if the negotiation has not achieved the desirable result.

The legal regulation adopted in Russia and some states in Central Asia has not been chosen accidently as a legal background for this research. These states are rich by natural resources, particularly, oil and their laws have similar content regarding most of issues discussed below. Being former Soviet republics, Kazakhstan, Azerbaijan, Uzbekistan and Turkmenistan experienced the considerable influence of the Russian school of law, therefore, a vast number of Russian principles, institutes and rules were incorporated into the legislation of the above said states. This effect allows to conduct a comparative analysis of the chosen legal systems and to examine how ancillary legal risks arising from the performance of oil services contracts are addressed and solved in law.

II. SANCTIONS IN OIL INDUSTRY

Sanctions in the Oil Industry impose restrictive measures by a state, group of states or union of states against one or more states pursuing the prohibition of certain type of commercial or production activity. The most notorious example of such sanctions are the restrictive measures imposed by US, EU, Australia, Canada, etc. as a response on Russia's actions "destabilising the situation in Ukraine" — the wording used by the above said states. These Russia-related sanctions (hereinafter referred to as Sanctions) apply to natural and legal persons and certain sectors in Russian Oil Industry — deep water, Arctic offshore, and shale projects. The effect of the Sanctions regulation has a twofold character. On the one hand, it prohibits residents of the states which adopted the Sanctions to carry out commercial activity in the restricted sectors and/or with restricted persons under the threat of significant fines. On the other hand, it releases them from claims submitted relating to

contracts or transactions the performance of which has been affected by the restrictive measures.[2]

In this regard, the most critical issue from the contractual point of view is how to address the Sanctions in the service contract. Clients located in states against which the Sanctions were adopted prefer to consider them as **Force-Majeure** circumstances. Such approach allows them to terminate service or delivery contracts without being liable for payment of compensations, cancellation fees or recovery of damages. Also, the Client is usually inclined to shift the burden of audit for compliance with sanction regulation to the Contractor providing that the latter should indemnify and hold the Client harmless against any claims arising from the failure of the Contractor to obtain the required authorisation documents if it is necessary to comply with applicable export and trade control laws. The other negative consequence for the Contractor is the complexity to prove that adoption of new Sanctions which may come into force after the prolonged period of discussion in Parliament or other competent state authorities was unpredictable.

Another disputable issue is the uncertainty of classifying events as Force-Majeure or Hardship. The former excuses a party from its liability under the contract if some unforeseen event beyond the control of that party prevents it from performing its contractual obligations.[3]

The *Turkmen* model uses only one word — "insurmountable" to characterize such events,[4] the *Kazakh, Uzbek* and *Russian* models add the words: "extraordinary" and "unavoidable".[5] The *Azerbaijani* model prefers to confine itself to the statement that the debtor could not have foreseen the event which prevented it from performing of its contractual obligations (like the ICC model) or its removal or elimination or its

[2] Art. 11 of the Council Regulation (EU) No. 833/2014 of 31.07.2014. Concerning restrictive measures in view of Russia's actions destabilizing the situation in Ukraine.

[3] ICC Force Majeure Clause 2003 / ICC Publication No. 650, 2003.

[4] Art. 410 (1) of the Civil Code of the Republic of Turkmenistan adopted by the Act No. 294-1 on 17.07.1998 (CCoT).

[5] Art. 359 (2) the Civil Code of the Republic of Kazakhstan (General part) adopted by the Ruling No. 269-XII on 27.12.1994. (CCoK); Article 401 (3) of the Civil Code of the Russian Federation adopted by the Act No. 51-FZ on 30.11.1994 (CCoR) Art. 333 of the Civil Code of the Republic of Uzbekistan adopted by the Act No. 163-I on 21.12.1995. (CCoU).

consequences.[6] Also, the *Kazakh* model provides an inexhaustible list of examples of Force-Majeure events, indicating a natural disaster and armed conflict, and a single example of event which shall not be considered as Force-Majeure— the absence of goods, works and services necessary for performance in the market. The *Russian* model adds two more cases: a violation of duties on the part of the debtor's contractors and the lack of necessary cash resources on the part of the debtor.

A service contract may subsume the Sanctions under the list of events to be considered as Force-Majeure under the contract by using the following wording: "act of authority whether lawful or unlawful, compliance with any law or governmental order, rule regulation or direction."[7] Even though Sanctions correspond with this enumeration of events the interested party needs to prove that it could not reasonably have avoided or overcome the effects of Sanctions to be qualified as Force-Majeure. In accordance with the ICC model **Hardship** provisions may be applied if the continued performance of contractual obligations has become excessively onerous due to unforeseen event beyond the control of the interested party and entail not an excuse from liability but re-negotiation of the contract. Moreover, this event could not reasonably have been expected to be considered at the time of the conclusion of the contract.

The idea of re-negotiation is implied in the *Turkmen*, *Uzbek, Azerbaijani* and *Russian* models based on change of the contract when a hardship occurs. All of them contain an important reservation that hardship provisions shall be applied only to a material change of circumstances, which is deemed to have such characteristic when the parties would not have concluded the contract or would have concluded in significantly differing conditions if they could reasonably foresee this change.[8] The *Azerbaijani, Uzbek* and *Russian* models admit further dissolution of the contract by court[9] where the *Turkmen* model entitles

[6] Art. 448.4 of the Civil Code of the Republic of Azerbaijan adopted the Act No. 779-IQ on 28.12.1999 (CCoA).

[7] ICC Force Majeure Clause 2003 / ICC Publication No. 650, 2003, par. 3.

[8] Art. 409 (1) of CCoT; Art. 383 of CCoU; Art. 422.1. of CCoA; Art. 451 (1) of CCoR.

[9] Art. 422.3. of CCoA; Art. 383 of CCoU; Art. 451 (2) of CCoR.

the aggrieved party to unilaterally refuse from the performance of the contract.[10]

Also, *Azerbaijani, Uzbek* and *Russian* models establish certain conditions which shall simultaneously exist to make the required remedy sustained by court. The first category relates to the conclusion of the contract when the parties relied on the fact that the material change would not occur and the custom or essence of the contract does not allocate the risk of the material change to the aggrieved party. The second category relates to performance of the contract. The aggrieved party has to prove that it could not overcome the causes of the material change with that degree of care and circumspection which was required of it by the character of the contract and conditions of the business intercourse. Also, it should prove that performance of the contract without the required change of its terms and conditions would cause such damage for the aggrieved party that it would be deprived to a significant degree of what it estimates at the time of the conclusion of the contract.[11]

The most obvious areas in the Oil Industry affected by Sanctions are goods, services, technology provided to major subsoil users in Russia in support of oil exploration or production for Deep Water, Arctic Offshore or Shale projects in Russia. The ban for the Contractor to involve specially designated persons or entities, export prohibited items, provide a deferral of payment may cause serious impediments for the Contractor to perform the contract but are unlikely to amount to an absolute impossibility of performance. In any event, a check is needed to ensure what options may be used by the Contractor to substitute prohibited items, technology or make a shift to a prepayment basis.

Considering the ambiguous qualification of consequences resulted from Sanctions, the Contractor importing services or goods into the state against which the Sanctions were adopted prefers to reserve the unilateral right to terminate the contract without considering such termination as a breach of this contract and obtain a confirmation from the Client that the latter shall have no legal cause of action and waive

[10] Art. 409 (4) of CCoT.

[11] Art. 422.2. of CCoA; Art. 383 of CCoU; Art. 451 (2) of CCoR.

any right to assert the same. It would be better for the Contractor if the Client shall also be obliged to furnish all relevant information and details about the Buyer and its operations including provision of end user certificates or other documentation that may be required by the appropriate licensing authority.

It should be noted that allocation of risks between the Parties if one of them fails to comply with Sanction regulation is closely connected with governing law and dispute resolution clauses. Notwithstanding that the former's scope does not extend to the rules of public law to which Sanction regulation is supposed to belong there may be different results when applicable law considers Sanctions as a violation of International law and therefore vindicates the infringer or prescribes it to comply with local rules to affirm national sovereignty and inadmissibility of interference into national policy. As for an arbitration clause, particularly as to place of arbitration, arbitrators may consider lex arbitri to prevent the losing party from submitting a motion to set aside the award and make it enforceable if assets of this party are in this state.

III. ANTI-CORRUPTION POLICY AND OWNERSHIP DISCLOSURE

It has become a tradition for the Client to force the Contractor to accept Term and Conditions governing the requirements on Anti-Corruption Policy and Ownership Disclosure which are elaborated in favour of only one party — usually, the Client. Some of the requirements are impossible to perform, some of them are redundant and others incur unjustified consequences. The first category concerns the Contractor's obligation to disclose the whole corporate structure (chain) of owners and ultimate beneficiaries. This obligation may be established by the Client as a part of tender documentation and considered as enforceable if it is imposed on all tenderers.[12] However, disclosure of the whole corporate structure cannot be applicable to stock-exchange listed public companies as they do not have account information about most of their shareholders and their direct holdings. Individual stock

[12] Letter of Ministry of Economic Development 12.08.2015 No. D28i-2421.

ownership disclosure is made solely by stockholders and is made only at certain periods of time over the year. The Contractor's disclosure about stockholdings may be not updated and its correctness depends solely on the disclosure made by such stockholders. The ownership disclosure requirement may be partly performed by reference to the corresponding Stock-Exchange web site (publicly accessible source) from which the Client can download all accessible information and disclosure of ultimate corporate owner. The disclosure of any excessive information may be qualified as a breach of the "fair information disclosure" rules of the Securities and Exchange Commission and may result in sanctions imposed on the disclosing party.

The second category imposes redundant obligations, for instance, regular browsing the Client's web site to be familiar with the Client's internal policy and standards of anti-corruption regulation.

The third category endows the Client with a right to unilaterally terminate the contract if the Contractor fails to be compliant with requirements on Anti-Corruption Policy and Ownership Disclosure. This remedy is considered to be rather severe as it may be implemented by the Client even if there is no harm or damages caused by the Contractor. Possible defence in such cases may be a reference to unfair and burdensome contractual terms which significantly violate the balance of the Parties' interest due to their unequal negotiation opportunities. The Contractor should enjoy its rights based on model of a contract of adhesion if it manages to prove that disputable terms were determined by the Client and the Contractor had no opportunities to delete or revise them.

The *Uzbek, Kazakh* and *Russian* models use the word "burdensome" to describe unfair contractual terms of a contract of adhesion. This characteristic is added by a clarification that the adhering party would not have accepted these terms had it the opportunity to participate in determining the terms and conditions of the contract.[13] The reform of Russian Civil Code in 2015 adopted two important rules in favor of an adhering party. First, it abolished a former condition that the adhering party — entrepreneur shall not be aware of or shouldn't have known of

[13] Art. 360 of CCoU; Art. 389 (2) of CCoK; Art. 428 (2) of CCoR.

unfair terms to enjoy the right for dissolution or change of the contract of adhesion. Second, it allowed to apply the adhesion model to other types of contracts of the contractual terms are determined by one of the parties and other party due to unequal negotiation opportunities is put in a difficulty to negotiate other content of contractual terms.[14] Unfortunately, these two amendments have not been incorporated into the *Uzbek* and *Kazakh* models which nullify the entrepreneur's right to rescind or change a contract of adhesion.[15]

The *Azerbaijani* and *Turkmen* models tackle the problem of unfair contractual terms using another wording — "standard terms" of a contract which are preliminary couched in by one of the parties for multiple usage.[16] In contrast to the above said models they envisage more radical consequence if the standard terms contradict with principles of trust and fairness — invalidity of contractual terms.[17]

It is very important for the Contractor to start collecting evidence immediately after receiving an Anti-Corruption Policy and Ownership Disclosure by addressing the Contractor's negative attitude regarding relevant clauses and proposing amendments to the contract to mitigate unjustified and unfeasible demands. Good arguments may clearly demonstrate the obvious unfairness of burdensome terms, on the one hand, and the Contractor's weakness in drafting contractual terms. In any way if the Client decides to enjoy its right to unilaterally terminate the contract, the Contractor's counterclaim may be demand on repudiation or alteration of the contract in part devoted to Anti-Corruption Policy and Ownership Disclosure. State courts are inclined to settle such disputes in favour of the Contractor as a weak party qualifying burdensome terms as unfair and void.[18]

Anti-Corruption Policy and Ownership Disclosure may be ineffective if these requirements have declarative character without the Client's right to have access to the Contractor's financial statements, bills of

[14] Art. 428 (2) and (3) of CCoR.

[15] Art. 360 of CCoU; Art. 389 (3) of CCoK.

[16] Art. 417.1 of CCoA; Art. 356 (1) of CCoT.

[17] Art. 420.2 of CCoA; Art. 360 of CCoT.

[18] Paragraph 9 of the Ruling of High Arbitration Court of the Russian Federation No.16 on 14.03.2014.

lading, returns, and other books and to conduct any necessary audits. Besides providing out relevant records the Contractor is obliged to ensure that all persons involved into performance of the contract fully cooperate with the Client, including by agreeing to be interviewed by the Client's designee. Such requirements may contradict the Contractor's obligations to keep confidentiality in relation to its subcontractors or any other third parties.

Also, the Contractor is obliged to indemnify the Client from any third party's costs, fines, moral harm and property damage paid by the latter to settle lawful claims submitted by third parties relating to violation of Data Privacy Protection law. Such violation may happen if the Contractor fails to receive a consent from its employees or other affiliated persons which data should be disclosed to the Client pursuing Anti-Corruption Policy and Ownership Disclosure. The amount of administrative fine for processing Data Privacy without the owner's consent is usually not significant in terms of business.[19] Other sums, such as moral harm or property damage are hardly assessed when the parties enter into the contract.

IV. VIOLATION OF PUBLIC LAW

It is a common view that contractual terms and conditions address only the issues of private law. Tax regulation belongs to public law and envisages mandatory models which may be chosen by parties but not changed by them. However, implementation of tax rules may incur private consequences, i.e. obligations to commit certain actions or damages sustained by the party violating tax legislation. One of such consequences relates to qualification of a contract as a controlled transaction.[20] The signs of such type are not necessarily connected with interdependent persons and may appear in international sale-purchase

[19] For instance, the amount of fine to be imposed on the entity-offender under Art. 13.11 of the Code of administrative offences of the Russian Federation adopted by the Act No. 195-FZ on 30.12.2001 (ACoR), is 75 000 Rubles (approximately 1 000 USD with currency rate 1 USD = 60 Rubles).

[20] Art. 105.14 (1) of the Tax Code of the Russian Federation adopted by the Act No. 146-FZ on 31.07.1998 (TCoR).

of goods and transactions where one of the parties is located due to its incorporation, domicile or place of tax residence in the state or territory included into the tax heaven jurisdictions list approved by the competent state authority.[21] As these factors may be found in contracts for the provision of oil services and goods the controlled transactions requirements are still urgent for parties who try to do their best to release themselves from relevant liability, damages or losses. The Buyer prefers to impose an obligation on the Seller to provide the former with information which is necessary for preparation of documentation certifying correspondence between the contract price and market price. Due performance of this obligations means disclosure of the data based on profitability, amounts of revenue and costs, economic efficiency and other factors to be disclosed in accordance with the tax legislation.[22] That such disclosure may affect the Seller's commercial secrets and therefore raise strong objections from the Seller's legal team. The possible compromise should be based on fair attitude to allocation of risks between the parties and true contemplation of aims pursued by tax authorities.

Any attempt made by a taxpayer to share its tax responsibility with a contractor cannot be substantiated by contractual needs. It is not fair for the Buyer to shift its obligations to disclose price formation to the Seller if the latter is not affiliated with the Buyer. Moreover, the local tax law releases a taxpayer from such burden of proof if the transaction is concluded between persons who are not considered as interdependent ones.[23] Therefore, any indemnity obligations to compensate any sums imposed by tax authorities and sustained by the Buyer are hardly acceptable from the Seller's point of view. These sums may be indemnified by the latter if the Buyer has proved that tax sanctions were caused by the Seller's failure to provide the Buyer with

[21] In the Russian Federation, it is a Minister of Finance (Order of Ministry of Finance of the Russian Federation on 13.11.2007 No. 108n "On approving of the list of states and territories providing a favorable tax regime and/or failing disclosure of information in carrying out financial operations (offshore zones)").

[22] Letter of Ministry of Finance of the Russian federation on 30.08.2012 No. OA-4-13/1433@ "On preparation and submission of documentation on the purpose of tax control".

[23] Art. 105.15 (4) of the TCoR.

the required information and not by the Buyer's incorrect interpretation of tax legislation or its failure to provide tax authorities with the required information in due manner and time, and also if the Buyer exhausted all remedies to defend its interest before state courts.

Another instance of private consequences arising from violation of public law relates to currency regulation and control requirement to be observed by the parties if one of them is non-resident and their contract may be qualified as cross-border transaction. A resident shall bear administrative liability if it fails to fulfil certain obligations envisaged in the local legislation which consists of two widespread categories. The first one is the most important and therefore imposes the highest liability. A resident is obliged to ensure that all goods and services provided for a non-resident shall be duly paid by the latter in accordance with the contractual terms and conditions or ensure that all money prepaid for a non-resident shall be returned if the latter failed to provide relevant goods and services. If the resident fails to do so it shall pay a daily rated or a fixed fine which may amount to a significant sum.[24] The second one envisages less sanctions for minor offences, i.e. undue submission of accountable forms, reports, statement to the authorised body of the currency control relating to performance of the cross-border transaction and execution of its passport to be issued for each contract. The resident's failure to comply with the above said requirements causes impositions of a fine which amount is not significant.[25]

Obviously, the party cannot feel itself safe relying on sole behaviour and willingness to comply with currency regulation and control requirements. An offence may be induced by unfair actions of the other party who refuses to duly perform its contractual obligations. To mitigate its risks the Client prefers to enhance the Contractor's liability by imposing a special fine which shall be paid in addition to

[24] In accordance with Art. 15.25 (4) of the ACoR if the resident fails to do so it shall pay a penalty in the amount of 1/150 of refinancing rate fixed by Central Bank of the Russian Federation from the sum of non-payment per each day of delay or pay a fine in the amount of ¾ or full sum of money not wired to the bank accounts in the authorized banks.

[25] Depending on the length of delay the amount of the fine may achieve 50 thousand Rubles (Art. 15.25 (6) of ACoR).

damages sustained by the Client due to violation of currency regulation and control legislation. This special fine may be qualified as punitive damages as it shall be paid over actual harm suffered by the Client and usually is fixed regardless of the extent of the relevant offence.

In some cases, this harm even may not occur at all. The classic example is a fine imposed on the Contractor for detecting alcohol intoxication of its employees when they are located at the Client's site. This fine has mostly a disciplinary character as it is directed towards ensuring all personnel at the site to observe Health, Safety and Environment Policies adopted by the Client. However, the impressive amount of the fine per each occurrence[26] is obviously incommensurate to the consequences of the contractual violation as no harm to the Client's property or business may occur at all. In this case the interested party is entitled to ask the court for reduction of the fine.

The *Turkmen* model only mentions about the right of a court to reduce incommensurate penalty.[27] *Azerbaijani* model also confirms this right and emphasizes that the court shall consider the Creditor's property rights.[28] The *Kazakh* model makes one important reservation that the condition of such reduction shall be submission of the corresponding statement to be made by the Creditor before the court. Moreover, it adds the list of factors to be considered by the court in reducing the penalty in question: extent of performance of obligations carried out by the Debtor and its interests.[29] The *Russian* model clarifies the definition of incommensurability and condition for reduction of the penalty. In relation to the first one it envisages that the right to reduce the penalty shall be enjoyed by the court if the penalty is clearly incommensurable to the consequences of the contractual violation. In relation to the second it makes a reservation that the requirement to submit the statement is applied only to the Debtor-entrepreneur. As for the list of factors to be considered by the court in reducing the penalty in question the *Russian*

[26] The amount of the fine for detecting of the Contractor's employees in alcohol intoxication at the Customer's site may amount to 300 000 Rubles (approximately 5 000 USD (currency rate 1 USD = 60 Rubles).

[27] Art. 430 of CCoT.

[28] Art. 467 of CCoA.

[29] Art. 297 of CCoK.

model names them as extraordinary cases if it is proved that payment of penalty may cause unjustified benefit for the Creditor.[30]

Despite the possibility of reduction of an incommensurate penalty state courts reluctantly sustain the corresponding motions submitted by the Debtor-entrepreneur as the general trend is not to revise the mutual intent of the parties but enforce it for the sake of stability and predictability of business relationship. Therefore, the court will award penalty without reduction if it finds that the Contractor voluntary accepted the relevant obligation to pay such penalty and thereby agreed with its commensurability.[31]

V. CONCLUSIONS

The comparative analysis of the legal regulation adopted in Russia and some states of Central Asia shows that various tactics may be used by the Contractor during negotiations and performance of oil service contracts. In relation to Sanctions the Contractor's intent to envisage clear legal consequences occurring upon the adoption of any restrictive measures, for example, the Contractor's unilateral right to terminate the contract, is justified because of the uncertainty of legal instruments proposed by the applicable legislation, such as Force-Majeure and Hardship. As for the Client's demand to disclose the whole corporate structure of the Contractor, including all shareholders and ultimate beneficiaries, this may be qualified as unfair and burdensome contractual terms. The same qualification applies to the Contractor's obligations to provide financial data certifying correspondence between the contract price and market price for tax purposes, to pay special fines for violation of currency regulation and control legislation or other administrative offences committed by the Contractor's employees.

If the Contractor fails to convince the Customer in unfairness of commercial terms proposed by the latter there are other remedies which may be used by the Contractor. The statutory rules of the above said states endow it to repudiate or change unfair contractual terms and reduce incommensurate penalties or fines.

[30] Art. 333 of CCoR.

[31] Ruling of Federal Arbitration court of East-Siberia District No. A19-22866/10 on 29.06.2011.